

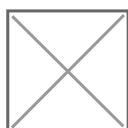
The US – crowding out?

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The term ‘crowding out’ has many different meanings but in economics it traditionally refers to the decrease in private investment that results from an increase in government spending. In economics, it is a phenomenon that occurs when greater government involvement in a sector of the market economy substantially affects the remainder of the market, either on the supply or demand side of the equation.

Crowding out can also mean to not allow a person or thing any space or opportunity to grow or develop. Over the past 20 years, driven by technological advances and the Global Financial Crisis of 2007/8 (GFC), we would argue that the US equity market has in essence crowded out all other markets through its unique position in the world.

The chart below shows the regional weightings of the MSCI World equity index since 1987 (EMEA is Europe, the Middle East, and Africa; APAC is Asia Pacific). It illustrates quite starkly how the US equity market has become more and more important for investors, ‘crowding out’ other regions with a near doubling of its weighting in the index, mainly at the expense of the Asia Pacific region. Japan accounts for a large part of this reduction, as its equity market peaked in numerical terms at the start of this chart and has only just recovered that level of pricing this week.



Source: MSCI, 2023

We have written often about how the US is an economic leader and how the US has been better at commercialising its research than almost every other country globally. This ‘exceptionalism’ is likely to remain a driver of the US economy for decades to come.

The question, looking forward, for investors is actually about how the disproportionate influence of the US market demonstrated in the chart above evolves from here. Does the US equity market continue to ‘crowd out’ all others or do some of the factors that have driven the concentration reverse, leading to a more diversified global index over time? The reason this is important is because, mathematically, the returns investors experience in the future will be better from those equity markets outside the US if catch-up is to occur.

A significant component of US equity market returns over the past 15 years has been a multiple expansion: this means that US stocks have become more expensive. If we presume no change in the valuation over the next decade, further multiple expansion will not be a driver of yet more ‘crowding out’.

Although valuations matter, we should not and do not underestimate the power of the technology cycle to preserve higher multiples in a few dominant companies that benefit from the networking effect of technological advances and have used the low interest rate world to cement their ability to keep ahead of the pack. This is why we have exposure to technology companies in all our strategies, even though their valuations are not cheap. A company can grow into its valuation.

As a counterbalance, one element of returns which has been ‘crowded out’ since the GFC is the value of dividends to investors. Dividends have just not been a large enough component of returns to resist the ‘crowding out’ US

exceptionalism. This is not the case in the next phase of global market evolution as dividends and their cumulative growth could well become a prominent factor in future returns from this juncture. The US equity market has a very low dividend yield when compared to other markets, as well as when compared to cash rates now available.

Tacit's unconstrained and active management of allocations to regional equity markets has not been key to returns over recent years, however, we anticipate that it will become very important again moving forward. Our strategies, for example, currently have close to 25% exposure to the Asia Pacific, compared with the MSCI World Index which has 10%, as we believe the companies in this region, their valuations, and their growing dividends will increasingly become a pull factor for investors over the coming years. Their valuations should rise accordingly.

Longer term historical analysis shows that the probability is that the chart above will become more diversified over the coming years rather than more concentrated towards the US.

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